Special Section: The Valley's Top Luxury Real Estate Agents

GREATER PHOENIX

inBusiness

THE MAGAZINE FOR BUSINESS SUCCESS

DEC. 2015

Creating Jobs

'Simple' Solution for Our Economic Success

Keeping Business All in the Family

The War for Talent

Nonprofits: Fundraising to Success

in THIS ISSUE

Scottsdale Area Chamber of Commerce

National Association of Women Business Owners – Phoenix

$4.95 INBUSINESSMAG.COM

Keeping Business in the Family Way

I.R.S. rumored to be slightly backing off proposed attack on family business

by Darren T. Case

Earlier in May, Cathy Hughes, an attorney-adviser for the Estate and Gift Tax Policy Office for the United States Department of the Treasury, sent shockwaves into the tax and estate planning community by announcing that new regulations would be implemented to make it much more difficult for families to transfer a family business to the next generation utilizing business valuation discounts.

Before, family business owners had been effectively using valuation discounts for decades, citing "lack of marketability" and "lack of control," among others, to transfer their business to their children or other family members, and lessen or avoid the estate tax impact on their death.

The Internal Revenue Service would love to do away with these discounts, but it has faced varied results in the U.S. Tax courts — and because of the lack of clear precedent, the I.R.S. would need assistance from the Department of the Treasury to do away with the discounts. Because the community has not seen movement to act on these measures, recent rumors are that the regulations may not be as far-reaching as the I.R.S. originally desired. However, if the I.R.S. were to receive the regulations, it would strongly curtail the tax-favorable transfers of businesses to the next generation and generate more revenue for the Department of the Treasury through increased collection of estate taxes. Without the regulations, the I.R.S. believes discounting may continue to be abused.

CURRENT BUSINESS ESTATE TAX LANDSCAPE

The types of valuation discounts under question by the I.R.S. and the Department of the Treasury are based upon general business principles, which is why they are struggling to come up with the new regulation.

In a non-familial sale of a business, the discounting benefits the buyer to the detriment of the seller, as less profit is being received from the sale. On the other hand, in an intra-family sale (or gift), while the seller would still receive less profit from the sale, it is presumed that the seller would still be satisfied, as it benefits not only their children but also avoids estate tax upon their death.

To illustrate the effectiveness of valuation discounts, assume that parents owned a family business worth $4 million and wished to gift or sell a 25-percent interest to their children. The book value of that 25-percent interest would be $1 million. However, due the "lack of marketability" and "lack of control" of the family business, a 35-percent discount is warranted in the gift or sale. Consequently, the 25-percent interest in the company could be transferred to the next generation at a value of $650,000. If the net worth of the parents were subject to federal estate tax, currently at a rate of 40 percent, the transfer of the 25-percent interest would avoid imposition of an estate tax of $140,000.

Darren T. Case is a tax and estate planning shareholder attorney for Tiffany & Bosco, P.A. He is the co-author of the *Arizona Estate Planning and Probate Handbook*, former president of the Estate Planning, Probate & Trust Section for the Maricopa County Bar Association, vice president for the Central Arizona Estate Planning Council, and was recognized as a Super Lawyers Southwest Rising Star in 2015.

Tiffany & Bosco, P.A.
tblaw.com

Where taxpayers view this as an advanced estate planning technique, the I.R.S. believes that these discounts have been abused. For example, families have gone so far as creating family businesses solely for implementing the technique, where the family contributes marketable securities, cash or other liquid assets to the newly formed business and then gifts or sells fractional share interests at discounted rates shortly thereafter. While one would assume that the I.R.S. would be successful in challenging taxpayers abusing valuation discounts, the results within the U.S. Tax Court have been mixed, generally tilting in favor of the taxpayers.

WHAT THIS MEANS FOR BUSINESSES

The extent of the Department of the Treasury's aid to the I.R.S. has remained a mystery, but the latest rumors from Washington, D.C., have led tax practitioners to believe the new regulations will apply only to the "abusive use" of the law, and discounting would still apply to legitimate operating businesses in which the taxpayer is actively involved.

Perhaps the Department of the Treasury was swayed by the scathing open letter to the I.R.S. by a prominent Chicago attorney, who used 30 pages to criticize proposals limiting or eliminating discounts in family business transfers. Or perhaps the I.R.S. saw potential difficulties in litigating against taxpayers with the new regulations where more time was needed to refine the regulations.

Whatever the reason for the delay in the release, business owners who desire to transition their business to the next generation or potentially lessen their estate-tax burden should contact their trusted tax and legal professionals to discuss what impact these rumored regulations may have on their family. Furthermore, it is recommended that families sit down to discuss estate planning and business matters, which often is beneficial to the process and could avoid misunderstandings upon the transition of a business. ■

According to the Joint Committee on Taxation's publication "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," only 0.2 percent of the U.S. population owe any estate tax. The percentage is this low due to estate tax exemptions in 2015 and estate planning attorneys utilizing the tax code to the benefit of taxpayers. jct.gov/publications.html?func=startdown&id=4744